European M&A Construction Monitor
Trends for 2011–2013: Defaults, Deleveraging, Diversification and DBFM

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1. Introduction

M&A activity is expected to increase, although the average deal size will be smaller compared to previous years

We are pleased to present the second edition of the European M&A Construction Monitor. This monitor looks at the latest trends and issues in Mergers & Acquisitions (M&A) in the construction industry. This 2012 publication complements the "European Powers of Construction" (EPoC) of 2011: a Deloitte research paper examining the status of major European listed construction companies.

This monitor looks not only back at recent activities but also forward. Deloitte has produced this outlook by combining the in-depth, local knowledge of its European member firms on M&A, real estate, construction and infrastructure.

Market trends: Defaults, deleveraging, diversification and DBFM

The number of deals decreased in 2011 compared with 2010. Uncertainty in the market was a major factor for this decline. Although uncertainty remains omnipresent in 2012, M&A activity is expected to increase, even though the average deal size will be smaller compared with previous years. Small and medium-sized companies are the main targets, provided they are of interest to the limited number of larger construction companies active in the European M&A market.

Survival techniques – including deleveraging, diversification and reorganisations – have been and will continue to be applied to avoid defaulting on financial obligations. Companies that do not attract the attention of potential acquirers must be skilled in these techniques if they are to outlive financial turmoil and avoid financial distress. Many bankruptcies have been recorded in the last twelve months. Financially weak construction firms that remain inert, hoping for the economic situation to improve, could soon be heading for bankruptcy.

We have also noted larger construction groups fleeing Europe to markets where there is either evidence of recent growth or expectation of growth in the near future. These markets include BRIC countries (Brazil, Russia India, and China), Australia and the Middle East. Conversely, non-European international construction groups are keeping an eye on the European construction industry to identify potential targets.

This European M&A Construction Monitor presents analyses of market trends in the European construction industry: looking back but also looking forward.

2. Looking back

The European construction sector recorded 104 deals in 2011[1]

Development 2011-2012 H1
M&A activity within the European construction sector decreased in 2011 compared to the modest increase in activity the year before. In 2011, 104 deals were completed compared to 144 deals in 2010.

In last year's European M&A Construction Monitor we mentioned that the number of transactions was expected to increase in the medium to long term, depending on the availability of cash and other effects of the slow economic recovery. A year later, we can conclude that M&A activity has been adversely affected by the economic downturn and the contraction of available cash in the financial markets. This effect was felt most in 2011.

With 72 transactions in the first half of 2012 (2011 H1: 65 deals), the total number of deals in 2012 is expected to be higher than the 104 deals recorded in 2011 (including 2012 H2 projection based on linear extrapolation). Nevertheless, the deal value of individual transactions is expected to be lower than previous years.

Construction companies are broadening their traditional construction offering by acquiring smaller, add-on and niche companies which operate in other industries. This trend in diversification has resulted in more cross-sector mergers, with the aim of reducing the dependency on the struggling construction markets. The number of cross-border deals increased from 30% of recorded deals in 2010 to just under 40% of recorded deals in 2011.

This significant increase is in line with last year's internationalisation expectations. Since transactions were conducted mainly by international construction groups and conglomerates, the increasing presence of large, international and multi-disciplined construction companies is becoming stronger.

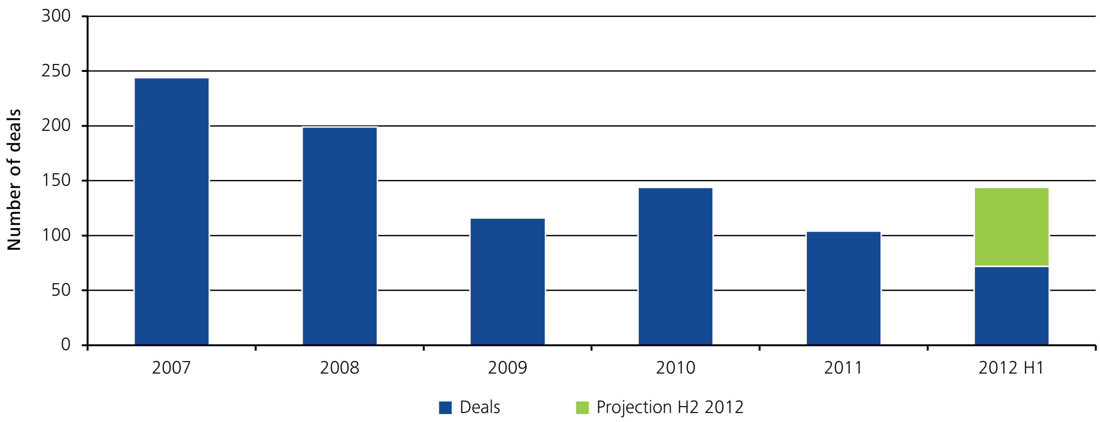
Last year we introduced and discussed the following trends: sector diversification and internationalisation. This year we will discuss the market trends of defaulting construction companies and deleveraging strategies. We will also discuss diversification (a follow-up on last year's trends) and DBFM.

Trend 1: Defaults

A large number of construction companies throughout Europe are currently defaulting on their financial obligations. Significant pressure on pricing is the main reason. This pressure is due to overcapacity in the market, which in turn is a result of the limited number of construction projects, the limited availability of funding and the low level of economic activity in the region. The pipeline of available work is running low throughout Europe, and is almost dry in Southern and Eastern European countries.

The impact of the crisis is most significant on small and medium-sized companies because they do not have the financial resources or buffers to diversify or raise capital. Nowadays, diversification and funding appear necessary because the lack of large contracts is causing large corporations to chase smaller contracts. This had led to a distorted market.

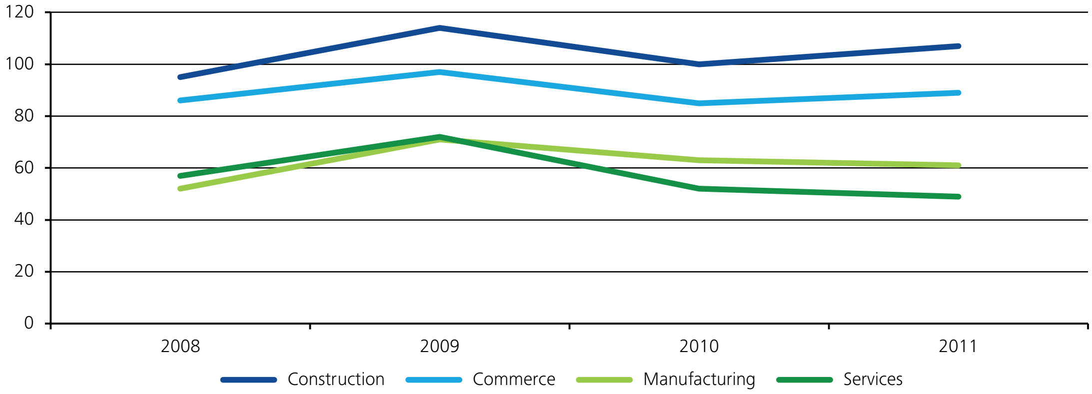
M&A activity European construction industry



1 A deal is a transaction involving at least 30% of the shares of a European construction company

Insolvencies per 10,000 companies in Europe*

**excluding Central and Eastern Europe*



Smaller companies are typically acquired when they become financially distressed. The distressed or defaulted company becomes a target if it has certain specialist ("niche") skills, a reasonable order portfolio and/or a presence in a market that the acquirer wishes to enter. Unfortunately, many of these distressed companies do not fit the requirements of acquirers currently active in the market. This has resulted in a wave of unsold smaller companies throughout Europe. Unless they are skilled in survival techniques, these companies face a constant threat of insolvency, default and – lastly – bankruptcy.

Insolvency is the inability to meet one's debt obligations. The figure above shows the number of insolvencies per 10,000 companies in Europe (excluding Central and Eastern Europe) in four sectors: construction, commerce, manufacturing and services. The construction sector recorded the most insolvencies. The trend is rising, which may indicate an increase in future bankruptcies.

The effect of large sporting events on the local construction sector has been remarkable. Local Deloitte specialists have indicated the termination of large sporting events as an immediate cause for a sharper increase in the number of defaults.

A good example is EURO 2012 in Poland and Ukraine. The football tournament attracted large infrastructural and construction projects to improve logistics for the large crowds attending the event. This subsequent peak in construction in the period before the event led to construction companies adjusting their capacity plans. However, the beneficial effect of EURO 2012 was short-lived. Considerably fewer construction projects have followed after this peak and this bodes ill for construction companies. A further rise in defaults is expected.

Bankruptcy PBG

In June 2012, Polish-based PBG announced bankruptcy. The group, which was Poland's third largest builder, was responsible for constructing three of the four stadiums for the 2012 European Football Championship. The company, which originally specialised in oil and gas engineering, tendered for the arenas and road works of EURO 2012. Once they had won the contracts, their debt levels soared and their margins were squeezed, resulting in large negative cash flows. The company generated revenue of over EUR 900 million and had more than EUR 1.5 billion of assets in 2011.

Trend 2: Deleveraging

Most construction companies use leverage, i.e. debt, to finance investments and operations. Unfortunately, leverage magnifies both gains and losses, thereby increasing the risk of default. Deleveraging – a company's attempt to decrease its amount of debt financing – is an important survival strategy for many construction companies throughout Europe. Deleveraging can be done by divesting a company of its assets and non-core activities, by selling additional equity to private equity firms or by exchanging debt-for-equity investments. Divestment reduces the overall financial risk of the company and can generate additional funds for more liquidity. The cash generated can be used to provide an equity buffer for new investments or to reduce debt and, therefore, the risk of default.

Historically, the working capital of construction companies was financed by milestone payments from their clients; therefore, additional financial resources were seldom required for working capital facilities. However, the unfavorable economic climate of the last few years and the lower number of contracts has resulted in the negotiation of these favourable conditions by clients. Consequently, construction companies have had to find other ways of financing work in progress, shifting a significant share of the financial risk from the client to the construction company.

This fundamental change in the business model has made it necessary for most companies to restructure their balance sheets and financial reserves. The low availability of credit throughout the European financial markets, partly caused by a host of new regulations such as Basel 3 and Solvency 2, has forced companies to consider deleveraging. Divestment of non-core activities or assets generates additional cash, reduces risk and improves the company's efficiency by shifting its focus to its core business. Overall, construction companies reduced their net debt by 3%[2] in 2011. We expect a further reduction in 2012 and beyond.

Another trend is the increasing interest of private equity in construction companies. Private equity firms acquire stakes in a company using a debt-for-equity swap: private equity is used to redeem debt, improving the debt-to-equity ratio. An alternative method is to issue more equity or by selling private equity firms a stake in existing equity.

Selling equity to private investors means passing partial control to others while keeping a strong balance sheet with healthy financial ratios. These strong financial ratios and larger cash supplies enable companies to initiate new investments and negotiate more favourable terms for their debt covenants.

Deleveraging through asset sale – Ferrovial

A notable case of deleveraging by selling assets is the sale by Ferrovial of a 10.62% stake in BAA Ltd to Qatar Holding LLC for GBP 478 million in August 2012. BAA Ltd owns, amongst others, Heathrow and Stansted airports in London. The sale of these shares follows an already extreme deleveraging strategy of 74% (EUR 14,618 million) of Ferrovial's net debt in 2011.

Private equity – Miller Group

An example of the increase in private equity is the acquisition in December 2011 of a controlling stake in house building, property development and construction company Miller Group by GSO Capital Partners (a subsidiary of The Blackstone Group, United States) with a deal size of GBP 160 million (involving a capital injection and a debt-for-equity swap). This transaction improved Miller's debt-to-equity ratios, allowing it to refinance its remaining debt for more favourable conditions.

2 European Powers of Construction (EPoC) 2011

Trend 3: Diversification and DBFM (PPP)

Excess capacity and pressure on margins have resulted in companies seeking other opportunities to remain profitable during a widespread economic downturn. Similar to last year, and in line with the expectations of international Deloitte specialists, we have seen an increase in diversification through cross-border and cross-sector M&A activity. These acquisitions remain popular in volatile markets because they ensure sustainable long-term profitability.

We have also seen around the world an increasing number of PPPs. Public Private Partnerships in infrastructure and construction projects are often structured as long-term DBFM contracts (Design Build Finance Maintain). Construction companies participating in these structures extend their involvement in the project (value chain integration); a specific form of diversification.

A. Internationalisation: cross-country and cross-continent

Previously, diversification happened mainly across other European countries. Focus has now shifted to the BRIC countries (Brazil, Russia, India and China), Australia and the Middle East. These countries are expected to be responsible for more than half of the worldwide infrastructure investments in the coming years. This creates a sustainable growth market for local companies as well as for foreign companies who enter the market at an early stage. Entrance to these markets is mainly executed through joint ventures, mergers, public private partnerships (PPPs) and selected tenders.

The internationalisation trend is being driven mainly by large, cash-rich construction companies that currently have the financial resources to pursue this strategy. We also see an increasing amount of investment in Europe by Chinese firms. Cash-rich Chinese construction companies are looking for opportunities to expand into new markets by extending their construction and technological knowledge. An example from earlier this year (February 2012) is the acquisition of Putzmeister, a German-based manufacturer of concrete pumps, by Sany Heavy Industry from China. The transaction price was USD 525 million. More cross-continental acquisitions between China and Europe are expected.

Cross-continental diversification – Bilfinger

German-based Bilfinger SE acquired Indian-based Neo Structo Construction Ltd for a non-disclosed priced on 23 November 2011. This acquisition in the Indian industrial service market marks the German company's first entry into the Asian continent. Some of Neo Structo's clients were already being served by Bilfinger in other countries. The Indian company currently employs 1,600 people and has an enterprise value of EUR 60 million. Neo Structo focuses on the maintenance, manufacturing and installation of facilities in the process industry, which greatly resembles Bilfinger's current business model. This is the first overseas cross-continental diversification for Bilfinger.

Companies based in Southern Europe are moving towards projects in Northern Europe, a more stable part of the continent economically. There is also an increasing amount of shorter-term, project-based internationalisation between these regions. In Southern Europe, the amount of available work is decreasing rapidly, but in some countries in Northern Europe, the economy is starting to stabilise. Cross-border interference is putting even more pressure on the margins of local companies, creating the need to diversify into other more profitable sectors.

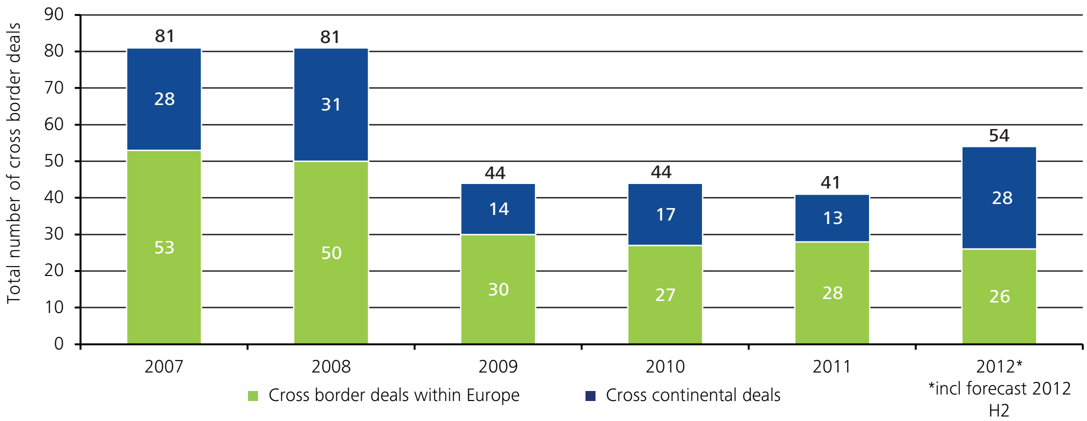
As stated before, the number of cross border deals increased from 30% of 144 recorded deals in 2010 to just under 40% of 104 recorded deals in 2011. The absolute number declined slightly in 2011 (41) compared to 2010 (44). However, we expect this number to increase in 2012. We also expect more cross-continental deals at the expense of fewer cross-border deals within Europe. This follows the trend of the increasing number of overseas acquisitions by European companies.

B. Sector diversification

Cross-sector acquisitions not only reduce dependence on the current volatile construction market but also increase opportunities to create synergies within the value chain and boost overall profitability. Our dataset of deals shows an increase in cross-sector deals. A more significant increase in cross-sector M&A activity has been observed when it comes to smaller-sized companies, which fall outside the scope of this research paper.

Since the European construction market is deteriorating, construction companies are looking for opportunities to diversify their activities by entering other, more profitable sectors. These mergers are mainly within higher value or service industries like telecommunication, green energy and motorway operations because they complement current core business expertise. However, the average deal size of mergers within the construction industry continued to decrease in 2011 because these more knowledge-driven, add-on companies are situated mainly in less capital-intensive niche markets and are, therefore, generally smaller in size. Logically, the growing amount of defaults and financial problems experienced by small and medium-size companies is increasing the possibility for larger companies to adopt this strategy. Therefore, we expect a further increase in sector diversification.

Cross border deals within Europe and cross continental deals



C. Design Build Finance Maintain

As stated earlier, in addition to sector diversification we also see an increase in vertical integration of the value chain. In the current economic climate, the life cycle of buildings is starting to take a more prominent role in the construction of real estate. This results in construction contracts which integrate the DBFM of infrastructure or building projects for the entire life cycle. It means contracts can often run for up to 50 years, generating stable and/or more secure cash flows for the parties involved. It also results in cost reductions because overhead costs and overall risk are limited.

These DBFM contracts are often created as a partnership between public and private parties (PPPs). Within this partnership, the public party receives guarantees of costs, scheduling, materials and operations for the entire duration of the project. Deloitte specialists have noted this solution is gaining in popularity. It offers construction companies the opportunity to initiate cross-border and cross-industry partnerships with diversified risks and reduced initial start-up costs.

We foresee an increasing interest in international infrastructure projects by European construction companies. An example in this is the partnership between construction companies Hochtief (Germany), ACS (Spain) and Meridiam (France/North America) to carry out the USD 1.5 billion project on the North East Anthony Henday Drive in Canada. The DBFM contract will run for 30 years and includes operation and maintenance of the existing highway infrastructure.

There is also increasing opportunity in Europe for large European builders to get involved in DBFM contracts. Two examples of international interest are located in the Netherlands. Currently, the A15 motorway is being built by a consortium composed of Strukton and Ballast Nedam (Netherlands), John Laing (UK) and Strabag (Austria). In the first bidding round of the A1/A6 motorway, a losing consortium included Acciona (Spain) and Besix (Belgium). One of the three teams that advanced to the next round included a consortium of FCC (Spain), Strukton CC (Netherlands) and John Laing (UK). Even though it is unclear which companies will carry out this DBFM project, it is clear that there is a growing presence of international construction companies in local PPP and DBFM markets.

3. Going forward

The outlook on M&A activity in Europe

M&A activity in the construction industry for the coming years remains difficult to predict. However, we do expect an increase in M&A activity and private equity transactions in the European construction industry from 2012 onwards. Construction companies are focusing on remaining profitable, and several are trying to move their investments overseas to diversify existing businesses suffering from the economic climate in Europe.

The table below provides a quick overview of the opinions of local Deloitte specialists on the short to medium-term outlook of M&A activity within their local market. Subsequent pages provide more extensive views by region.

Northern Europe

Northern European countries seem to be less influenced by the economic downturn than the rest of Europe. This results in an increase of inbound investments from foreign companies as well as outbound investments in other construction markets. Nevertheless, local Deloitte specialists note that less interest in diversification across industries and borders is being recorded in Scandinavia compared to other parts of Europe since the domestic market is still offering sufficient opportunities.

Country	Outlook[3]	Highlights
Belgium	o	• Increase in number of foreign investments in Belgium
Czech Republic	–/o	• Relatively stable private sector, restricted public investments • Limited opportunities to sell distressed companies • Large number of defaults due to overcapacity
Finland	o	• Market expected to decline in 2013 • Large companies have international focus
France	o	• Companies exploring overseas opportunities • Diversification towards higher value industries
Germany	o/+	• Increasing sector diversification of construction companies • Notable increase in private equity
Greece	–	• Wave of cancelled PPP projects
Ireland	–	• Low M&A activity • Low expectations of future investments
Italy	–	• Bankruptcies increased significantly due to declining domestic demand • Strong international focus
Netherlands	o	• Domestic M&A activity expected to decline in a wave of (more) defaults • Largest construction companies focus on cross-border and cross-continental projects/targets • Move towards more 'services' and PPP (diversification) in medium term
Norway	+	• Continued high M&A activity expected • Increased interest from foreign investors and private equity
Poland	–	• Increase in defaults due to EURO 2012/contract mismanagement • Decreasing investment growth due mainly to low credit availability
Spain	–/o	• Strong focus on deleveraging • Reducing financing options • International focus on mitigating impact of declining domestic demand
Sweden	o/+	• Increase in domestic infrastructure projects • Companies investing actively outside domestic markets
United Kingdom	o	• UK companies remain attractive to international groups • Market expected to see increase in number of distressed companies

3 + optimistic; o neutral; – pessimistic

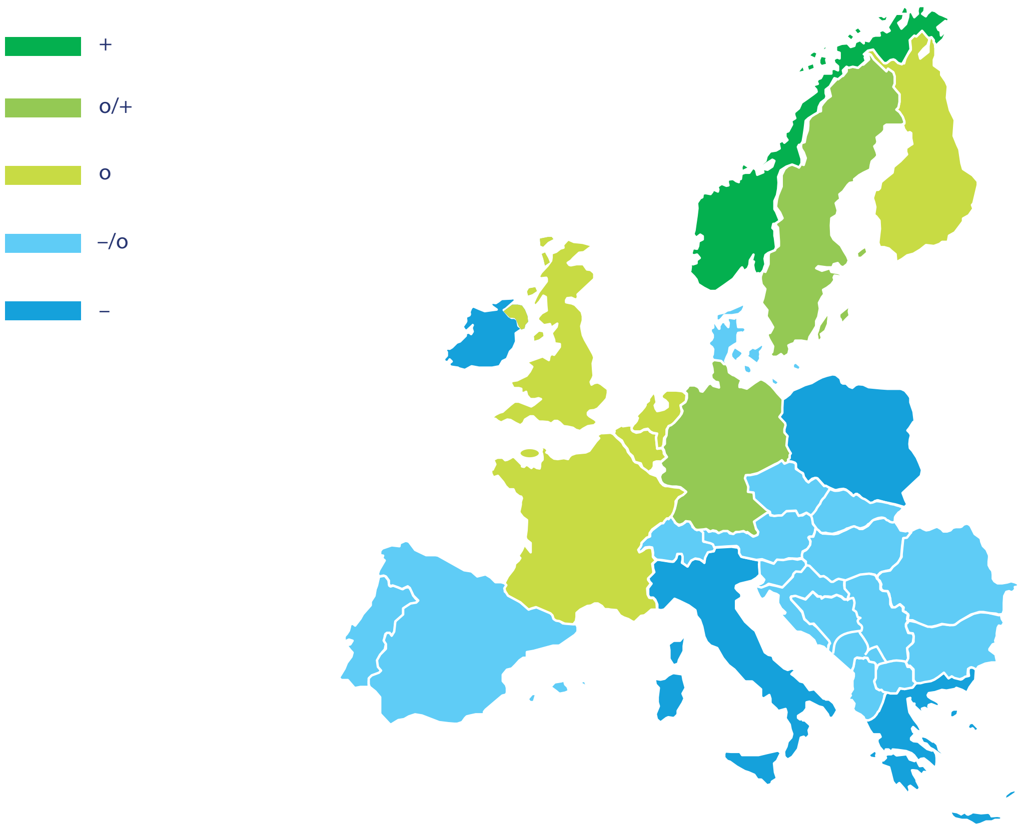
Northern Europe – Overview

Diversification, in particular internationalisation, is a trend in Scandinavian construction companies and can be seen in recent activity and in future strategic plans. Defaults have been registered, but to a much lesser degree than in other parts of Europe. Scandinavian countries seem to be effected less by the economic crisis than other European countries in general, making the Nordic countries an attractive target for joint ventures and takeovers.

Relatively high GDP growth, low unemployment, low interest rates, high population growth and increased government spending on infrastructure are fuelling the growth of the Norwegian infrastructure sector. Subsectors benefiting most from this growth are residential development and infrastructure (including road construction and energy/utilities). Infrastructure tenders have attracted many European construction companies. The following European players have participated in infrastructure tenders in Norway: Hochtief (Germany), Implenia (Switzerland), Torpol (Poland), MT Højgaard (Denmark), Bilfinger (Germany), E. Pihl (Denmark), Alpine Bau (Austria), Balfour Beatty Rail (UK), Marti (Switzerland) and Spitzke (Germany).

Bilfinger, Alpine Bau, MT Hoygaard and E.Phil all have a base in Norway. Both Alpine Bau and Hochtief are currently in joint ventures with Veidekke. To date, Implenia is the only larger European construction group that has closed a deal in Norway: in 2010 Implenia bought the majority of shares of Betonmast Anlegg AS, which was one of the largest independent infrastructure companies in Norway. Local Deloitte specialists foresee relatively high M&A activity in the construction sector: several large regional construction firms are aiming for national coverage and foreign construction companies are becoming more active.

Sweden's domestic M&A activity in the construction sector is stable. This activity comprises not only mergers between companies but also acquisitions of projects still in the pipeline and strategically placed land for possible future developments. Swedish companies are also active outside local borders. For example, Skanska AB, one of the largest Swedish companies, has acquired construction companies in Poland (PUDiZ Group, December 2011) and Finland (Soraset Yhtiot Oy, October 2011). Another example is Swedish NCC AB's acquisition (June 2012) of OKK Entreprenør AS, a Norwegian construction company. Current Swedish economic conditions are expected to attract even more international investment in the near future.



In Finland, growth in the construction market is expected to decline in 2012 and, despite the weak positive signals earlier this year, the decline is expected to continue until 2013. The uncertainty in the construction sector is high, so a recovery is not expected, at least not in the short-term. During the last twelve months, M&A activity and defaults have remained modest in Finland. M&A activity has been focusing on diversification and the acquisition of small add-on companies in the maintenance sector. Large Finnish construction companies have expansion plans that are internationally focused, the main target being acquisitions in Russia.

There have been defaults in the Northern part of Europe: Strukton Rail AS (Norwegian subsidiary of Dutch construction group Strukton Rail) filed for bankruptcy in Norway in January 2012 because of low margins and organisational issues. Additionally, Norwegian state-owned road construction company Mesta Entreprenør AS reported that they will be winding up their business in the coming years.

Western Europe

Construction companies in Western Europe are pursuing diversification with cross-border and cross-sector M&A activity, aiming to minimise the effects of the current economic climate in their local construction industry. In the long term, we foresee Western European construction companies continuing to adopt geographical and industrial diversification strategies.

French construction companies are actively exploring overseas investment opportunities in North America, India and North Africa to reduce their dependence on domestic sales. An example is the acquisition in late 2011 of Bermingham Foundation Solutions (Canada) by Soletanche Freyssinet, a French engineering company and subsidiary of Vinci Construction. Within France, diversification is concentrated on higher value industries. Vinci has also been applying this strategy to the European market: in April 2012 Vinci acquired Alpiq's energy and infrastructure telecommunication business in Germany and Central Europe for EUR 195 million.

Western Europe – Overview

M&A activity remains low in Western Europe and is mainly triggered by diversification to higher value industries and private equity interference. Several defaults have been recorded, especially in the Netherlands and the UK: this applies in particular to smaller and medium-sized construction companies. The larger companies are focusing more on reducing their reliance on the European market by focusing on worldwide emerging markets.

UK companies, currently attractively priced, remain of interest to international construction groups hoping to acquire specialist skills or broaden their geographical footprint. However, many companies within the UK are feeling the effects of the financial downturn because of significant pricing pressure and market contraction. These companies often remain unsold if they lack specialist skills that could be used to diversify potential acquirers. Private equity money has also started to flow into the UK, though the market remains turbulent. We expect financial distress to continue in the sector.

In Germany, larger companies are following the trend of diversifying towards higher value industries. Smaller companies are consolidating in order to survive the current economic downturn and stay profitable. Within Germany, a notable increase in private equity has been recorded, following the deleveraging objectives and requirements of construction companies. A recent example of private equity activity (October 2011/March 2012) is the purchase of 15% of the shares in Bilfinger by Swedish investment firm Cevian Capital.

The construction market in the Netherlands recorded a small growth in investments of 4% in 2011, but is significant when compared to the negative growth (-8%) in 2010. Unfortunately, we do not believe the positive growth is sustainable. The economy has since deteriorated; real estate markets are in particular turmoil due to great uncertainty arising from unclear long-term government plans for this market and its key stakeholders. The largest construction companies are focusing on investments outside the Netherlands and probably outside Europe. An example of cross-continental acquisition is the takeover of Canadian-based McNally Contractors Ltd by Royal Dutch Volker Wessels Stevin NV in June 2011. A large wave of reorganisations and defaults is hitting the Netherlands. A case in point is Moes Bouwgroep. This construction company had around 1,000 employees before 2007. The workforce was cut to 150 before the company eventually defaulted in July 2012. Another trend within the Netherlands seems to be the use of bankruptcy to lay off large number of (expensive) employees, only to restart with a downsized company. For the medium term, local Deloitte specialists expect to see more construction firms turning to DB(F)M/PPP projects and diversifying into services and maintenance.

Geographical diversification deals are being recorded in Belgium. For instance, the acquisition of Hirler Vaeplan GmbH (Germany) by Imperbel NV, both operating in the roofing industry. Foreign investors are also active in Belgium. Many of these deals involve private equity investors like the Dutch Gilde Equity Management Benelux BV, which has acquired a glass bead production company, Sovitec SA from another private equity firm.

In Ireland, M&A activity is very low because of severe financial conditions. The local construction market is weak, which has resulted in very little foreign investment into Ireland, though some cross-border acquisitions have been completed. The largest deal (EUR 65 million) in 2012 was the acquisition of a – relatively small – part of ThyssenKrupp, a listed German-based global steel listed company, by Kingspan Group Plc, an energy efficiency solutions company. Kingspan bought ThyssenKrupp's business with high-quality steel products for the construction industry with plants in Germany, Austria, France, Belgium and Hungary. Local Deloitte specialists believe the level of defaults has peaked. They do not anticipate major large scale defaults with main contractors going forward.

Central and Eastern Europe

In Central and Eastern Europe, the construction industry is encountering significant overcapacity. This requires entrepreneurial creativity and sound solutions. Overcapacity has resulted in significant price wars between construction companies: strategic collaboration and M&A has become more desirable and profitable. Diversification towards Russian and Middle Eastern markets as well as towards different sectors, including more technological niche markets, is also gaining in popularity.

The industry has placed its recovery hopes on PPP projects. PPP projects should increase the chance of surviving the current economic situation by increasing available work (direct effect) and stabilising the flow of income and expenditure (indirect effect). In the Czech Republic, construction companies should look to other means: local Deloitte specialists report that the current decrease in activity relates primarily to a reduction in public sector and infrastructure projects.

Several companies have faced a decrease in turnover by almost 50%, which has resulted in a large number of defaults throughout the Czech Republic and Poland. Two reasons for this are reduced EU funding and the reduced demand for construction work. The difference between supply and demand has resulted in extreme price negotiations, which became abundantly clear during the realisation of EURO 2012 construction projects. Negotiations gave rise to low prices with low margins for most projects. However, these prices had not taken market risks and rising material costs properly into account. This resulted in a loss on most of projects which in turn resulted in defaults.

Central and Eastern Europe – Overview

The sharp decrease in construction activity and the large gap between supply and demand is causing serious market imbalance in Central and Eastern Europe. This has resulted in a significant number of defaults but has also opened up opportunities for foreign investment in these countries.

The Central and Eastern European markets are fragmented. This is expected to trigger consolidation and M&A deals in this region. Throughout Eastern Europe, owners of small and medium-sized companies are trying to sell their businesses, due mainly to generational change. They are finding it difficult to find buyers. Many of these companies are built around the director and majority shareholder, which complicates an acquisition. Credit availability in Poland will most likely diminish, but foreign direct investments are expected to increase, mainly by international companies that are already present in the market.

Southern Europe

The current economic climate in Europe is hitting Italy, Spain, Portugal and Greece particularly hard. The construction markets are declining drastically, forcing business models in the construction market to adopt renewed and revised strategies.

For many years, the larger Italian construction companies have been shifting their focus to the international market and they now derive around 50% of their revenue from international assignments, making them less exposed to the domestic market. Continued government pressure is keeping a tight control on investments in national infrastructure projects, which is having a greater effect on the medium-sized companies more focused on the domestic market. This trend is likely to continue in the short to medium term. Local Deloitte specialists expect medium-sized companies to explore M&A opportunities and joint ventures in order to maintain a reasonable market position, access more international opportunities and reduce costs. Foreign investors are expected to seek small add-on niche companies for both geographical and sector diversification. Larger companies in these countries are starting to focus on regions other than domestic markets. They are turning, in the main, towards the Middle East, North Africa, North America, Russia and other markets, where large infrastructure projects are being developed.

Southern Europe – Overview

There has been an increasing amount of defaults among small and medium-sized companies throughout Southern Europe. Larger companies that do survive are focusing on overseas and Northern European projects where possible. A current lack of overall money within their governments and within the market means recovery will be slow, and M&A activity will be mainly from outside these countries.

The situation in Italy, Spain, Portugal and Greece has been further complicated by reduced financing options as well as the reduced solvency of companies. Since 2009, bankruptcies in the Italian construction sector have increased by 25%. Tighter financing requirements from banks and limited opportunities to divest existing developments will lead eventually to further financial distress within the sector.

Reduced government spending in Italy, Spain, Portugal and Greece has triggered a rush of cancelled PPP projects. This will result in financial distress for small companies involved in these PPP projects. Nevertheless, some projects in Greece may restart in the coming years.

The Spanish construction market has deteriorated during recent years, reaching its lowest level in the first half of 2012. Activity within the real estate sector, public construction tenders and construction companies decreased considerably in 2012 year on year. New PPP projects are projected, but financing is expected to become a major problem for almost all projects. Therefore, numerous construction companies are now focusing on overseas activity, targeting other investment grade countries through acquisitions or partnerships in consortiums. Most players within the Spanish construction industry are divesting their non-strategic assets and restructuring their debt and will do this repeatedly in the future.

To conclude: what to expect

A year after publishing the first edition of the European M&A Construction Monitor, we can conclude that the construction industry in Europe has not been able to pull itself out of the doldrums. Many construction companies are struggling because of a declining order book and the limited availability of funding. Thousands of construction companies across the board are failing.

Each construction company is handling the situation differently. Some companies are looking to other countries and/or participating in PPPs and DBFM projects. They are being increasingly attracted by other continents and higher value industries and focusing increasingly on activities in maintenance and services. These construction companies still have the chance to tackle and survive the current situation. Other companies are looking internally and/or domestically; they either do not want or do not have the ability to adopt cross-border and cross-sector M&A strategies. Their focus is on internal organisation. They need to answer important and critical questions such as 'What should the scale and scope of our business be to survive?', 'How do we control our business (centralisation vs. decentralisation)?', 'How can we meet our (financial) obligations?' and 'Which assets and/or business units should be sold or terminated to generate additional cash and/or reduce costs?'.

Differences also exist between countries and regions within Europe. Scandinavia, in particular Norway, is doing relatively well. An increase in government spending is partly responsible for this limited recovery. Nevertheless, M&A activity remains at a modest but stable level, which makes this market considerably more attractive than the Irish market, where M&A activity is close to zero. Other parts of Western Europe have been recording mainly smaller-sized M&A deals and an increasing number of defaults. A turnaround in the short-term is not in line with expectations. This, unfortunately, applies to Central, Eastern and Southern Europe as well.

Companies should be evaluating and adapting their strategies. High on the agenda should be improving financial ratios and changing financial management to meet these new strategies. Strategic partnerships, innovation and working capital reduction should also be considered priorities. With respect to 2011-2012, local Deloitte specialists report that companies under pressure choose to sell assets and/or businesses, attract private equity in exchange for shares and control, and lay off employees in large numbers.

In the short-term, we expect M&A activity to continue at the current level, which is characterised by a limited number of deals and relatively smaller deal sizes for Europe as a whole. As previously mentioned, differences between countries and regions exist. The number of distressed companies is expected to increase, as is the number of bankruptcies, leading to a process of consolidation in the European market. In the medium term, we anticipate consolidation in the European construction sector to continue through M&A activity, albeit at a slower pace than previously expected. We also expect larger European construction companies to continue expanding across sectors and beyond Europe for the next few years.

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